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Supreme Court of the United States.

OCTOBER TERM, 1949.

NICHOLAS W. MATHEY,
Petitioner,

v.

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FIRST CIRCUIT

AND

BRIEF IN SUPPORT THEREOF.

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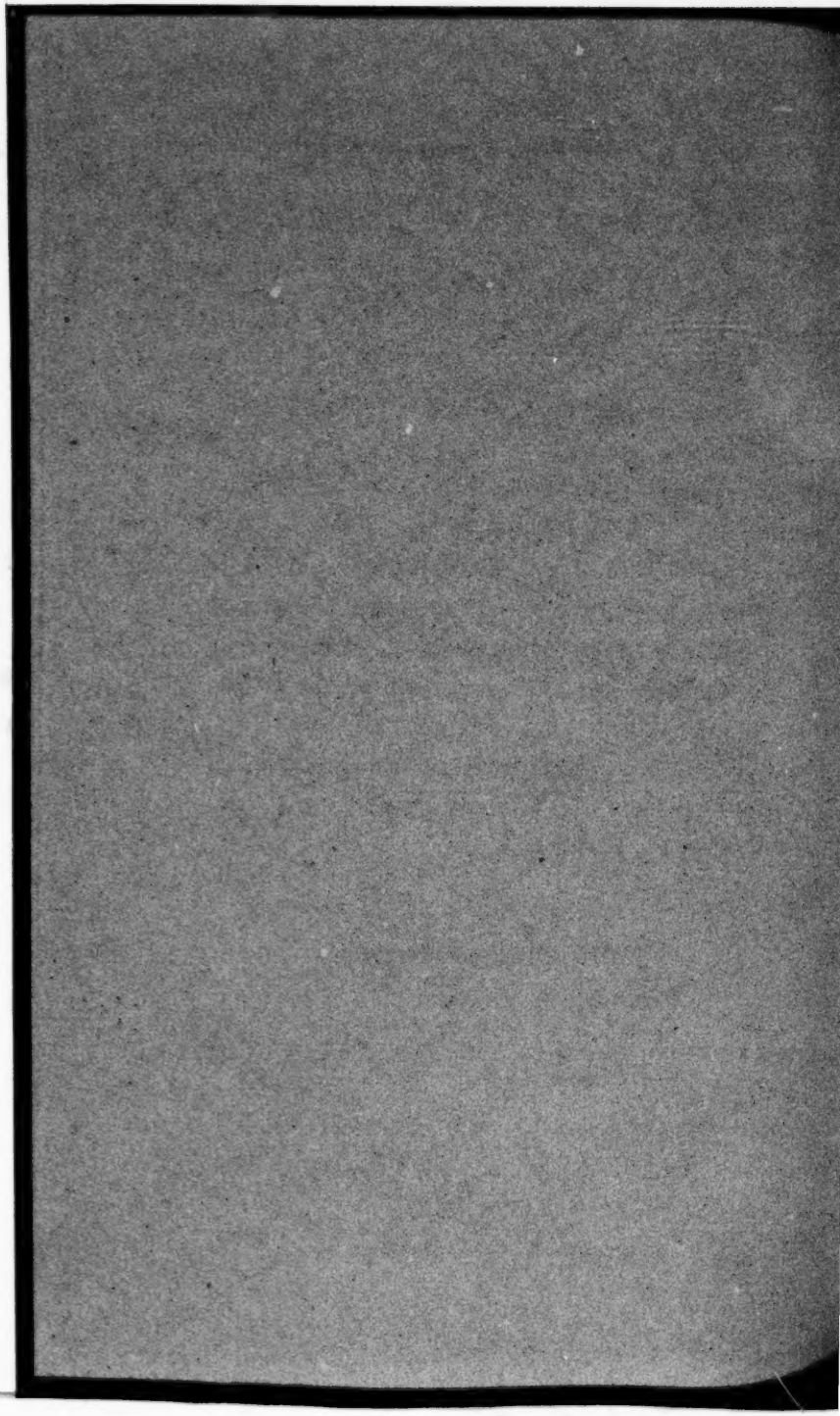

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PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FIRST CIRCUIT.

To the Honorable Chief Justice and Associate Justices of the Supreme Court of the United States:

The petitioner, Nicholas W. Mathey, prays that a writ of certiorari may issue to review the decree of the Court of Appeals for the First Circuit entered October 19, 1949, in the above case, docketed in said court as No. 4407. Said decree affirmed a decision of The Tax Court of the United States that the net amount received in a patent infringement suit (charging damage to the plaintiff through the defendant's infringement) is taxable as ordinary income in full on the grounds that the award recovered was for profits, royalties and interest, that the "tax benefit rule" is inapplicable in the absence of any showing that tax deductions were taken prior to the year in which the tax was assessed, and that the gain received could not be considered as a capital gain since there was no "involuntary

conversion'' of any part of petitioner's patent within the meaning of Section 117(j) of the Internal Revenue Code.

Opinions Below.

The findings and opinion of the Tax Court are reported in 10 T.C. 1099, and printed in the record, pp. 104-115. The opinion of the Court of Appeals is reported in 177 F. (2d) 259, and is printed in the record, pp. 135-142.

Jurisdiction.

This court has jurisdiction to review the decree of the Court of Appeals for the First Circuit entered October 19, 1949, under U.S. Code, Title 28, Sec. 1254.

This application is made within ninety days after the denial of a petition for rehearing entered December 12, 1949 (R. 155), as required by Section 2101.

Questions Presented.

1. Is an amount received as an award in a suit arising out of the infringement of a patent, found by the court to be deliberate and for the purpose of destroying petitioner as a competitor, taxable income in the year received?

2. If any part of that award is income, may that income be offset by losses caused by the infringement in previous years from which no tax benefit was derived? If so, is petitioner entitled to a rehearing to offer additional evidence to prove the exact amount of said losses, where a petition for rehearing was seasonably made to the Tax Court with a detailed offer of proof?

3. Is the deliberate infringement of a patent for the purpose of destroying petitioner's business and which re-

sults in virtual exclusion of petitioner's machines from the trade an "involuntary conversion" of his patent under Section 117(j) of the Internal Revenue Code?

Statement.

In 1923 petitioner, who had been employed by the United Shoe Machinery Corporation (hereinafter called United) since 1908, went into business for himself under the trade name of the Hamlin Machine Company (R. 44), which he later incorporated. (R. 51.) Petitioner first began work on a flap trimming machine in 1925, and on May 22, 1929, had so far perfected it that he applied for a patent (R. 46-47), which was issued June 2, 1931. (R. 29.) In 1930 petitioner learned that United was selling or leasing similar machines for $4 a month and charging $68 for installations while he was asking $15 a month rental and $250 for installations. (R. 48.) Petitioner's business, which had shown every indication of becoming successful and profitable, was substantially destroyed by the competition of United. (R. 48-51.)

Formal notice of infringement was given by petitioner on July 29, 1931, and suit against United was instituted in the United States District Court for the District of Massachusetts on May 27, 1937. (R. 29.) A copy of the bill of complaint appears in the record. (R. 33-36.)

In an opinion dated April 23, 1940, reported in 32 F. Supp. 684, the court held that claims 2, 4 and 16 of petitioner's patent had been deliberately infringed and this was affirmed on appeal to the United States Circuit Court of Appeals for the First Circuit except that no costs were allowed. (Decision dated April 24, 1941, and reported in 117 F. (2d) 331.) The District Court appointed a special master to assess damages and determine United's profits. Petitioner waived his claim to United's profits except for

foreign sales and elected to recover his damages before the master. The master found that petitioner had been United's next largest competitor and that United deliberately offered its machines at rates "ruinous" to petitioner's business. (R. 107.) The District Court, by memorandum decision, reported in 54 F. Supp. 694, increased the award by 50% on account of United's deliberate infringement. (R. 111-112.) Judgment in the amount of $137,725.20 was entered on March 21, 1944, and was paid with $609.72 interest on April 17, 1944. (R. 30.) The District Court's interlocutory decree that claims 2, 4 and 16 of the petitioner's patent had been infringed, the interlocutory judgment on mandate of the Circuit Court, the District Court's order appointing a special master, and the judgment of the District Court are in the record. (R. 37-43.)

Legal fees and litigation expenses paid by the petitioner in connection with this suit amounted to $30,536.63. (R. 30.) Petitioner did not claim any deductions with respect to these fees in any year and in his return for the year 1944 included in his gross income only the amount of $688.47, which was that part of the judgment designated as the infringer's profits on foreign sales. (R. 31.) The respondent in his notice of deficiency allowed a deduction of $30,563.63 for litigation fees and expenses and assessed a deficiency on the balance of the judgment, $107,825.27. (R. 31.)

On November 14, 1946, petitioner received a notice of deficiency from the Treasury Department determining a deficiency in the amount of $80,815.14 for the calendar year 1944. (R. 9.) On February 6, 1947, petitioner filed a petition with the Tax Court for a redetermination of his 1944 tax liability. (R. 4-8.)

Three of the arguments made before the Tax Court are relied upon in this petition:

1. Petitioner first contended that the award was not taxable income (except that part representing United's profits on foreign sales) on the ground that the award was in substance for damage to petitioner's capital assets (R. 109-110), petitioner offering evidence that the net worth of the business had decreased from $374,883.03 to $44,-125.14 between October 14, 1930, and September 30, 1941, and that the decrease was caused by the infringement. (R. 129.) The petitioner also contended that the increase in the award was in the nature of a penalty against United for its deliberate infringement. (R. 111.) The Tax Court found that, although proceedings in the infringement suit indicated that the infringement was deliberate, the entire amount awarded by the master represented a recovery of lost profits and the increase in the award ordered by the District Court was to further compensate the petitioner for his lost profits rather than damage to the business or its assets, and, further, that it was not in any respect a penalty. (R. 110-112.)

2. Petitioner also contended that, if any part of the award rendered in the District Court was income, the so-called "tax benefit rule" should be applied with respect to losses caused by the infringement and deducted on petitioner's tax returns without tax benefit. (R. 110.) The Tax Court rejected this argument, stating that the petitioner had not shown the applicability of the rule (R. 110), and refused to grant the petitioner a further hearing upon his timely motion, which contained a detailed offer of proof of the exact amount of said losses so deducted without tax benefit. (R. 134.) (R. 129-131.) Petitioner also offered to prove facts further substantiating the basis of the assets of petitioner's business and the extent of their destruction. (R. 130-131.)

3. Petitioner further contended that any gain which he may have realized was taxable as a capital gain under

Section 117(j) of the Internal Revenue Code. (R. 113.) Petitioner testified that the competition of the infringing machines offered by United after 1930 practically destroyed that portion of his business dependent upon the flap trimming machine (R. 48), and that this competition so affected his business as a whole that he was unable to secure the necessary working capital to run the business properly. (R. 50.) Petitioner also introduced in evidence the master's report and the decision of the District Court holding that the infringement was deliberate and for the purpose of destroying petitioner's business under his patent and destroying petitioner "as a competitor in the shoe machinery business." (R. 144.) The Tax Court, however, held that the evidence did not show that any particular part of the patent having a disclosed basis was converted or destroyed and that United had merely usurped a non-exclusive license to manufacture and lease the patented machines. (R. 113.)

On September 14, 1948, petitioner filed a petition to review the decision of The Tax Court of the United States and assigned as error the court's decision on the above issues. (R. 119-120.)

The Court of Appeals, in its opinion dated October 19, 1949, found that damages awarded petitioner in his infringement suit were compensation for profits or gains which petitioner would have received except for the infringement and taxable as ordinary income. (R. 140-141.) The Court of Appeals also held that the tax benefit rule was inapplicable, among other reasons, because petitioner had failed to show that he took any tax deductions in the years prior to 1944 on account of the infringement. (R. 141-142.) The court stated that it had considered other contentions made by petitioner, but found them to be fully answered by the court below. (R. 142.) Petitioner's pe-

tition for rehearing, timely filed November 3, 1949 (R. 143-148), was denied December 12, 1949. (R. 149.)

Statutes and Regulations Involved.

The statutes and regulations involved are set forth in the Appendix, *infra*, pp. 21-24.

Specification of Errors.

Petitioner submits that the Court of Appeals erred—

1. In holding that the proceeds received by petitioner were lost profits, and in failing to hold that all or a substantial part of the proceeds were to compensate petitioner for damage to and destruction of the assets of his business.

2. In holding that petitioner had not demonstrated the applicability of the "tax benefit rule," and in failing to hold that petitioner sustained losses as a result of the infringement which he is entitled to recover tax free before any part of petitioner's recovery in 1944 is taxed.

3. If any part of petitioner's recovery is taxable income, the court erred in holding that said part is taxable as ordinary income rather than as capital gain from the involuntary conversion of the patent or business of petitioner.

4. In failing to remand the case to the Tax Court for a further hearing.

Reasons for Granting the Writ.

1. The decision of the Court of Appeals is erroneous and is in conflict with decisions of the United States Supreme Court, of the Courts of Appeals and with the Regulations of the Commissioner.

2. This case is of public importance, and the questions presented by petitioner are of importance in tax administration.

Respectfully submitted,

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BRIEF IN SUPPORT OF PETITION.

A. The decision of the Court of Appeals is erroneous and is in conflict with decisions of the United States Supreme Court, of the Courts of Appeals and with the Regulations of the Commissioner.

Petitioner contended before the Tax Court and the Court of Appeals that all or part of the net proceeds of the patent infringement suit recovered by him in 1944 constituted reimbursement for damage to his shoe machinery business and should be treated as a non-taxable return of capital. (R. 109.) (R. 141.) Evidence was offered showing that the net worth of petitioner declined from $374,883.03 to $44,125.14 during the infringement period, and that this decline was caused by the infringement. (R. 129.) The record in the patent suit, which is a part of the record in this case, shows that the purpose of the infringement was, as the Federal District Court found, to destroy petitioner as a competitor, and that a substantial part of the award was for ". . . at least a part of the general damage inflicted on plaintiff's business under his patent." (R. 133.) The master's award was increased by the District Court by 50% or $45,687.77 because the infringement was deliberate and because "all the elements of damage done to the plaintiff" were not "included in the award made." (R. 108, 145.) The record also shows that the reduction in net worth resulted from a decrease in the value of assets which obviously had a basis; the record further shows that patents and goodwill were carried at one dollar and that these assets did not enter into the reduction in net worth. (R. 48-53.)

The Tax Court held that petitioner had not attempted to establish a loss under a specific provision of the Internal Revenue Code and had not offered evidence "to support fully the computation which would have to be made."

(R. 110.) The Tax Court further held that the recovery in the patent suit constituted in its entirety a recovery for lost profits, that no part of the recovery was attributable to the loss of capital and that evidence introduced in the Tax Court proceeding on this point was immaterial. (R. 111.)

Petitioner thereupon requested a rehearing within the time prescribed by the Tax Court rules (R. 129-134), and offered to prove with particularity the exact basis of the assets damaged by the deliberate infringement relying on—

> *Helvering* v. *Taylor*, 293 U.S. 507.
> *Durkee* v. *Commissioner*, 162 F. (2d) 184 (C.C.A. 6).

The petition for a rehearing was denied. (R. 129.) The Tax Court's decision was affirmed by the Circuit Court of Appeals. (R. 142.)

Petitioner submits that the decisions of the courts below deciding that the entire recovery was for reimbursement of lost profits are contrary to decisions of the Circuit Court of Appeals for the Sixth Circuit. It is obvious that a substantial part of the recovery was not awarded for lost profits of petitioner as such, but was for general damage properly allocable to the business. (R. 145.) It is self-evident that this deliberate infringement for the purpose (as the court found) of destroying petitioner as a competitor in the shoe machinery field (R. 137) at a time when petitioner was relying upon this patent to maintain his business in that field would have a disastrous effect upon his business and assets (R. 107); it is equally apparent that the master in the patent suit and the District Court intended a substantial part of the award to be compensation for this type of damage.

With respect to the increased award, the District Court, after finding that the purpose of the infringement was to destroy petitioner as a competitor in the shoe machinery field, increased the award by 50% or $45,687.77, saying that petitioner had incurred considerable expense and that—

> "there is little doubt that *all the elements of damage* done to the plaintiff are not included in the award made." (R. 111-112.) (Emphasis supplied.)

In the *Durkee* case the plaintiff had received $25,000 in settlement of a suit alleging contracts and business practices which deprived plaintiff of the right of free competition, resulting in great damage to plaintiff, destruction of his goodwill, and the loss of income of approximately $150,000. Plaintiff did not show the allocation of the settlement between damage to his assets and loss of profits, and the Tax Court held the entire award was taxable income. The Circuit Court of Appeals for the Sixth Circuit reversed, holding that the loss of profits under the circumstances was only an evidentiary factor in measuring the damage to the business and that "obviously a large portion, if not all, of the $25,000 received was in settlement of the lawsuit and in our view, was not taxable as a matter of law." (162 F. (2d) 184, 187.) Compare:

> *Farmers & Merchants Bank* v. *Commissioner*, 59 F. (2d) 912 (C.C.A. 6).

to the same effect.

The bill of complaint and prayers in the patent infringement suit involved here encompass damages of any nature (R. 35), and the record clearly shows that a substantial part of the award was intended to be for general damage to the business as distinguished from pure loss of profits.

It is submitted that the decision of the court below in the case at bar is plainly contrary to the decisions of the Circuit Court of Appeals for the Sixth Circuit cited above. The decision in the case at bar is also contrary to the decision of the court below in

Raytheon Production Corporation v. *Commissioner*, 144 F. (2d) 110 (C.C.A. 1).

The decision also conflicts with the decision of this court in—

Helvering v. *Taylor*, 293 U.S. 507—

and with that of the Sixth Circuit in—

Durkee v. *Commissioner*, 162 F. (2d) 184 (C.C.A. 6)—

on the question of the right of a taxpayer to a rehearing before the Tax Court.

Petitioner has clearly introduced sufficient evidence to show that the Commissioner's determination was "arbitrary and excessive." This showing is sufficient to entitle petitioner, as a matter of law, to a rehearing for the purpose of showing any additional facts necessary to compute the exact amount of the loss.

As the court pointed out in the *Durkee* case (p. 187), "in proceedings before the Tax Court, as distinguished from suits for refund in the district courts, it is sufficient to show that the Commissioner's determination is invalid," citing—

Helvering v. *Taylor*, 293 U.S. 507.

Petitioner submits that he has clearly met the burden of proof on the issue of the nature of the recovery.

Petitioner in his brief and argument before the Tax Court also contended that he should be allowed to set off

against any portion of the award held to be income those losses suffered by him during the infringement period and caused by the infringement from which he received no tax benefit. (R. 110.) (R. 141-142.) The Tax Court rejected this argument summarily by stating that petitioner had failed to show the applicability of the doctrine to petitioner's case (R. 110) and denied a motion for rehearing, which included an offer on the basis of newly discovered evidence to prove with particularity the losses caused by the infringement, and deducted on his tax return without tax benefit. (R. 129-134.) The Tax Court failed to cite any cases in support of its decision (R. 110), and the Circuit Court of Appeals in affirming the Tax Court likewise failed to cite any cases. (R. 141-142.) However, upon this issue the respondent relied on—

Burnet v. *Sanford & Brooks Co.*, 282 U.S. 359.

The above case was decided before the "tax benefit rule" had been developed and was expressly distinguished by this court in the case of—

Dobson v. *Commissioner*, 320 U.S. 489, 504.

Petitioner submits that the decision of the Tax Court, affirmed by the Court of Appeals, is contrary to and inconsistent with the *Dobson* case; as this court there said, failure of the courts to apply the "tax benefit rule" to bad debts had led Congress to extend relief and (p. 506)—

> "Congress would hardly expect the courts to repeat the same error in another class of cases, as we would do were we to affirm . . ."

The Regulations of the Commissioner issued after the decision in the *Dobson* case make the principle of the *Dobson* case expressly applicable to "*all* other losses, expenditures and accruals made the basis of deduction from gross in-

come for prior taxable years . . ." Regulations 111, Sec. 29.22(b)(12)-1. (Emphasis supplied.)

So much of the opinion in the *Dobson* case as deals with the jurisdiction of the Courts of Appeals to review decisions of the Tax Court must be considered in the light of the amendment of June 25, 1948, C. 646, Sec. 36, 62 Stat. 991, to Title 26, Sec. 1141. By this amendment the Courts of Appeals are given the same jurisdiction to review decisions of the Tax Court as of the District Courts in civil actions tried without a jury.

The Tax Court denied a rehearing to the petitioner upon his motion, timely filed, containing a detailed offer of proof as to the extent of his losses for which deductions had been taken without tax benefit in prior years, and the Court of Appeals affirmed this decision. (See R. 129-134, and R. 143-148, for petitioner's applications for rehearing.) Petitioner submits that the decision was also contrary to—

Helvering v. *Taylor*, 293 U.S. 507—

in failing to grant petitioner a rehearing on this issue.

B. This case is of public importance and the questions presented by the petitioner are of importance in tax administration.

Petitioner, before the deliberate infringement, had been United's next largest competitor, and the infringement was practised in such a manner that United must have known that it would be "ruinous" to petitioner as a competitor. (R. 107.) Petitioner had successfully competed in the shoe machinery field prior to the infringement, a field which has been notoriously dominated by one company for many years. (R. 107.) The only remedy offered by law to petitioner and his one hope for re-establishing himself in the domestic shoe machinery field was a success-

ful suit against United for patent infringement. After seven years of litigation (R. 29-30) petitioner proved that his patent was valid and deliberately infringed, and thereby partially re-established his goodwill and reputation and recovered a part of his lost capital necessary to refinance himself as an aggressive competitor in the field. He was, however, soon notified that, of the $107,215.57 which he had been awarded, he owed a tax deficiency to the Government because of that recovery, in the amount of $80,815.47, upon which 6% interest accrues. (R. 9.) Obviously the payment of any such amount will be a serious handicap to the petitioner in attempting once again to establish competition in the shoe machinery field. It is to be noted that this payment was made by United and undoubtedly deducted by it in 1944 (R. 30), an excess profits tax year. As matters stand, the cost of the deliberate infringement will have been largely paid by petitioner and the Government. Petitioner also submits that the case is of public importance because, if the deficiency determined against him is valid, it will have the effect of discouraging others who seek to vindicate their rights in the courts and reward those who seek to destroy competition through deliberate and ruinous patent infringement.

The questions presented by this petition are also of importance in tax administration. In the *Dobson* case the court held that the so-called "tax benefit rule" was an equitable principle which the Tax Court, as an expert body, should administer. However, Congress has provided that decisions of the Tax Court should be reviewed to the same extent as decisions of the District Courts in civil actions tried without a jury. (Chapter 646, Sec. 36, 62 Stat. 991, amendment to Title 26, Sec. 1141.) Having once granted certiorari to establish that the so-called "tax benefit" rule is within the exclusive domain of the Tax Court—

Dobson v. *Helvering,* 319 U.S. 739—

the court should now grant certiorari to petitioner for the purpose of stating the "tax benefit rule" which is to be applied by the courts.

Confusion presently exists as to the scope of the "tax benefit rule." The Commissioner in Regulations 111, Sec. 29.22(b)(12)-1 provided with reference to Section 22(b)(12) of the Internal Revenue Code:

> "The rule of exclusion so prescribed by statute applies equally with respect to all other losses, expenditures, and accruals made the basis of deduction from gross income for prior taxable years . . ."

The Regulations clearly extend the rule beyond so-called capital transactions. Congress has expressly extended the rule to certain non-capital transactions, such as bad debts, prior taxes and delinquency amounts. Internal Revenue Code, Sec. 22(b)(12).

However, the Circuit Court of Appeals and the Tax Court denied petitioner relief under the statute on the grounds that he had not shown any loss to capital assets for which he had received no tax benefit. (R. 110.) (R. 141-142.) As stated above, petitioner believes he has a right to offer further evidence to show said capital losses. However, assuming that no part of the recovery was for capital losses, the question of whether the "tax benefit rule" applies to other than capital transactions has been directly raised and in effect decided contrary to the Commissioner's regulations. It is submitted that this equitable principle should apply to any case where the loss and recovery constitute "an integrated transaction" (particularly where the recovery represents many years of losses received in one year through no fault of the taxpayer).

Dobson v. *Commissioner,* 320 U.S. 489, 502.

This case also raises the question of the extent of the discretion of the Tax Court in connection with rehearings as well as the scope of appellate review of Tax Court decisions. This matter is in a state of confusion.

Helvering v. *Taylor*, 293 U.S. 507.
Dobson v. *Commissioner*, 320 U.S. 489, 502.
Durkee v. *Commissioner*, 162 F. (2d) 184.
Bankers Pocahontas Coal Co. v. *Burnet*, 287 U.S. 308.
Chatham Phenix National Bank & Trust Co. v. *Helvering*, 87 F. (2d) 547 (C.A.D.C.).

As has been pointed out, this court held in the *Taylor* case that a taxpayer need only show that the Commissioner's determination is "arbitrary and excessive" in order to prevail, or at least to be entitled to a rehearing as a matter of law, and that he need not show the exact amount of the deficiency due.

In the *Dobson* case this court decided that at least as to matters of "tax accounting" decisions of the Tax Court are subject to limited review by the Courts of Appeals, and this restriction would appear to include questions involving burden of proof relating to tax accounting problems. The *Durkee* case, however, which was decided subsequently to the decision in the *Dobson* case, suggests that the decision in the *Taylor* case gives the Courts of Appeals greater scope in reviewing Tax Court decisions than they had with respect to District Court cases. This problem is further complicated by the passage of Chapter 646, Sec. 36, 62 Stat. 991, amending Title 26, Sec. 1141, which provides that the scope of review of Tax Court decisions by the Courts of Appeals shall be the same as the Courts of Appeals now have with respect to decisions of District Courts sitting without a jury. A question arises as to whether this statute impinges upon the decision of the court in the *Taylor*

case and as to its effect upon the *Dobson* decision and decisions of the Courts of Appeals.

Also contrast the decision of this court in the case of—

> *Bankers Pocahontas Coal Co.* v. *Burnet*, 287 U.S. 308—

with its decision in the *Taylor* case and with the decision of the Court of Appeals for the District of Columbia in

> *Chatham Phenix National Bank & Trust Co.* v. *Helvering*, 87 F. (2d) 547 (C.A.D.C.).

There is a further matter of importance in tax administration which would justify this court in granting this petition.

Petitioner argued in the alternative that, if any part of the proceeds of the infringement suit is taxable as income in 1944, that part should be taxed at long-term capital gain rates under Section 117(j) of the Internal Revenue Code.

Section 117(j) was inserted in the Internal Revenue Code by the Revenue Act of 1942. Its purpose was to relieve against hardships resulting from the taxing as ordinary income at high rates the proceeds of transactions involving the loss of or damage to capital assets in which the taxpayer had no freedom of choice. The section provides in effect that gains from the involuntary conversion of capital assets held more than six months shall be deemed to be capital gains and therefore taxable at a maximum of 25% instead of the graduated rates applicable to ordinary income. An involuntary conversion is defined in that section as—

> "the . . . conversion [of capital assets into money or other property] (as a result of destruction in whole or in part, theft or seizure, or an exercise of the power of requisition or condemnation or the threat or im-

minence thereof) . . ." (Internal Revenue Code, Sec. 117(j) (2).)

The instant case is the first to the knowledge of petitioner where the courts have passed upon the question of whether the partial destruction of an intangible capital asset (the patent) through wrongful acts of another is an "involuntary conversion" within the meaning of the statute. The Government has not contended that Section 117(j) is inapplicable to intangible capital assets, but has argued that the infringement did not constitute a conversion of any part of the patent because United did not claim title to the patent and petitioner still owned it after the infringement. The courts below accepted this argument.

But Congress was not concerned with technical concepts of title or the requirements for a conversion at common law when it passed this section. Under the statute, any partial destruction of a capital asset held for more than six months, without the consent of the owner, is a "compulsory or involuntary conversion" and the proceeds received on account of such conversion are taxed as long-term capital gains. There is no question but that the patent was a "capital asset" held for more than six months. Petitioner submits that an infringement found by the court to be for the purpose of destroying petitioner's business under his patent, and which is substantially successful in accomplishing its purpose, rendering the patent practically worthless, results in a "partial destruction" of the patent within the meaning of Section 117(j); it is equally clear that the amounts awarded petitioner (to the extent that they cannot be allocated to damage to petitioner's business as a whole) are in this case reimbursement for that damage to the patent.

Cf. *Dowagiac Manufacturing Company* v. *Minnesota Moline Plow Company*, 235 U.S. 641 (quoted by the Tax Court, R. 113).

The decision of the Tax Court that the infringement amounted to merely a non-exclusive license (R. 113) is highly unrealistic as applied to a situation where the infringer competes for the purpose of destroying the patent owner's business and is substantially successful in doing so. A non-exclusive license implies the right of more than one person to use the license on substantially the same terms. Nor is it necessary to show that a specific part of the patent is destroyed, or that it had a basis, as suggested by the Tax Court. A zero basis for the capital asset merely means that no part of the recovery is received tax free, but all is taxed—at capital gain rates.

> *Edward C. Myers* v. *Commissioner,* 6 T.C. 258, 261.

It is submitted that the courts below were clearly wrong on this issue.

It is of general public importance and of tax importance that this case be reviewed for the purpose of clarifying the law on the application of Section 117(j) of the Internal Revenue Code.

Respectfully submitted,

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Appendix.

Internal Revenue Code.

Sec. 22. Gross Income. [26 U.S.C. § 22.]

(a) General Definition.—"Gross income" includes . . . gains or profits and income derived from any source whatever. . . .

(b) Exclusions from Gross Income.—The following items shall not be included in gross income and shall be exempt from taxation under this chapter:

. . . . . .

(12) (as added by Section 116 of the Revenue Act of 1942, c. 619, 56 Stat. 798) Recovery of bad debts, prior taxes, and delinquency amounts.—Income attributable to the recovery during the taxable year of a bad debt, prior tax, or delinquency amount, to the extent of the amount of the recovery exclusion with respect to such debt, tax, or amount. For the purposes of this paragraph:

(A) Definition of Bad Debt.—The term "bad debt" means a debt on account of worthlessness or partial worthlessness of which a deduction was allowed for a prior taxable year.

(B) Definition of Prior Tax.—The term "prior tax" means a tax on account of which a deduction or credit was allowed for a prior taxable year.

. . . . . .

(D) Definition of Recovery Exclusion.—The term "recovery exclusion", with respect to a bad debt, prior tax, or delinquency amount, means the amount, determined in accordance with regulations prescribed by the Commissioner and with the approval of the Secretary, of the deductions or credits allowed, on account

of such bad debt, prior tax, or delinquency amount, which did not result in a reduction of the taxpayer's tax under this chapter (not including the tax under section 102) or corresponding provisions of prior revenue laws reduced by the amount excludible in previous taxable years with respect to such debt, tax, or amount under this paragraph.

. . . . . .

SEC. 117. CAPITAL GAINS AND LOSSES. [26 U.S.C. § 117.]

. . . . . .

(j) [as added by Section 151 of the Revenue Act of 1942, *supra*] Gains and Losses from Involuntary Conversion and from the Sale or Exchange of Certain Property Used in the Trade or Business.—

. . . . . .

(2) General rule.—If, during the taxable year, the recognized gains upon sales or exchanges of property used in the trade or business, plus the recognized gains from the compulsory or involuntary conversion (as a result of destruction in whole or in part, theft or seizure, or an exercise of the power of requisition or condemnation or the threat or imminence thereof) of property used in the trade or business and capital assets held for more than 6 months into other property or money, exceed the recognized losses from such sales, exchanges, and conversions, such gains and losses shall be considered as gains and losses from sales or exchanges of capital assets held for more than 6 months. . . .

. . . . . .

(B) Losses upon the destruction, in whole or in part, theft or seizure, or requisition or condemnation of property used in the trade or business or capital assets held

for more than 6 months shall be considered losses from a compulsory or involuntary conversion.

SEC. 1141. COURTS OF REVIEW. [26 U.S.C. § 1141.]

(a) Jurisdiction. The circuit courts of appeals and the United States Court of Appeals for the District of Columbia shall have exclusive jurisdiction to review the decisions of the Tax Court, except as provided in section 1254 of title 28 of the United States Code, in the same manner and to the same extent as decisions of the district courts in civil actions tried without a jury; and the judgment of any such court shall be final, except that it shall be subject to review by the Supreme Court of the United States upon certiorari, in the manner provided in section 1254 of title 28 of the United States Code.

TREASURY REGULATIONS 111, PROMULGATED UNDER THE INTERNAL REVENUE CODE.

Sec. 29.22(b)(12)-1 [as amended by T.D. 5454, 1945 Cum. Bull. 68]. RECOVERY OF CERTAIN ITEMS PREVIOUSLY DEDUCTED.—(a) In general.—Section 22(b)(12) provides that income attributable to the recovery during any taxable year of bad debts, prior taxes, and delinquency amounts shall be excluded from gross income to the extent of the "recovery exclusion" with respect to such items. The rule of exclusion so prescribed by statute applies equally with respect to all other losses, expenditures, and accruals made the basis of deductions from gross income for prior taxable years, including war losses referred to in section 127, but not including deductions with respect to depreciation, depletion, amortization, or amortizable bond premiums. (See *Dobson* v. *Commissioner*, 64 S. Ct. 239.) The term "recovery exclusion" as used in these regulations means

accordingly an amount equal to the portion of the bad debts, prior taxes, and delinquency amounts (the items specifically referred to in section 22(b)(12)), and of all other items subject to the rule of exclusion which, when deducted or credited for a prior taxable year, did not result in a reduction of any tax of the taxpayer under Chapter 1 of the Internal Revenue Code (other than a tax under section 102) or under corresponding provisions of prior revenue laws.

. . . . . .

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In the Supreme Court of the United States

OCTOBER TERM, 1949

No. 662

NICHOLAS W. MATHEY, PETITIONER

v.

COMMISSIONER OF INTERNAL REVENUE

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FIRST CIRCUIT

BRIEF FOR THE RESPONDENT IN OPPOSITION

OPINIONS BELOW

The findings of fact and opinion of the Tax Court (R. 104-115) are reported at 10 T.C. 1099. The opinion of the Court of Appeals for the First Circuit (R. 135-142) is reported at 177 F. 2d 259.

JURISDICTION

The judgment of the Court of Appeals for the First Circuit was entered on October 19, 1949 (R. 142). The taxpayer's petition for rehearing was denied by the court in an order entered Decem-

ber 12, 1949 (R. 149). The petition for a writ of certiorari was filed on March 10, 1950. The jurisdiction of this Court is invoked under 28 U.S.C., Section 1254.

QUESTION PRESENTED

Whether, in the circumstances of this case, the Tax Court was correct in holding that the net proceeds of a patent infringement award were taxable as ordinary income.

STATUTE AND REGULATIONS INVOLVED

These will be found in the Appendix, *infra,* pp. 12-15.

STATEMENT

The relevant facts on which both the Tax Court and the Court of Appeals were in agreement may be summarized as follows:

Taxpayer, a resident of Massachusetts, filed his individual income tax return in the tax year 1944 on a cash and calendar year basis. In 1931, while doing business as Hamlin Machine Company, he obtained a patent for a shoe machine. In that same year, he gave formal notice of infringement to United Shoe Machinery Corporation. In 1937, he brought suit for infringement against United, alleging in his complaint that but for the infringement he would have been "in receipt of large gains and profits", and that United had derived "great gains and profits" from its infringement. He asked that United be perpetually enjoined from further infringement, that it be ordered to pay

over both the profits that it made from its infringement and also the damages which the taxpayer had suffered therefrom, and that a master be appointed to take and state an account of the profits and to assess the damages. (R. 104-106.)

The District Court entered judgment for the taxpayer on three of the four patent claims pursuant to its memorandum opinion reported in 32 F. Supp. 684, affirmed, 117 F. 2d 331 (C. A. 1st), except as to an item of costs. On remand, the District Court entered a judgment on the mandate of the Court of Appeals awarding taxpayer the relief for which he had asked in his complaint, and appointed a master to take and state the amount of the damages taxpayer had sustained, and of the gains and profits which United had made by reason of its infringement of the three claims held valid. (R. 106.)

At the hearings before the master, taxpayer abandoned his claim for profits and pressed only his claim for damages which the master found amounted with interest to over $70,000. To this the master added interest on certain items of damages from a date prior to the liquidation of the damages because of "special circumstances." The special circumstances were that the defendant's infringement had been deliberate and premeditated and, for the purpose of destroying taxpayer as a competitor, United had pursued a pricing policy with respect to its infringing ma-

chines which it knew would be ruinous to taxpayer whose business was small and financial position was weak (R. 106-107). At the end of the report, the master stated that (R. 107): "The recovery allowed on the several elements of Plaintiff's 'Principal Claim' represents what has been proved to my satisfaction. As it does not represent the entire damage occasioned by Defendant's infringement and because of the 'Special Circumstances' I recommend to the Court that Plaintiff's damages be increased." In conclusion the master stated (R. 137-138):

> In accordance with the order of reference, I find that Plaintiff has sustained provable damages in the amount of $63,355.00 and is also entitled to recover profits made by Defendant in the amount of $688.89. With interest on the recoveries as reported, totalling $8,118.36, the total recovery to which Plaintiff is entitled on the facts herein reported is $72,162.25. In addition, I recommend the allowance of interest on reasonable royalty recovery and for recoveries based on lost profits from lost installation fees in the sum of $15,266.70, with any other factor or multiple of items found which to the Court should seem fitting in its discretion as provided by law to make the recovery by Plaintiff more nearly adequate to compensate him for the damage to his business under his patent.

The District Court confirmed the master's report in all essential respects and adopted the

recommendation that because of the "Special Circumstances" referred to by the master, interest should be allowed to run on the damages from a date prior to their liquidation (R. 108). In addition, the District Court adopted the recommendation that taxpayer's award be increased because United's infringement had been conscious and deliberate, stating in its unreported memorandum of decision (R. 111-112, 138):

> As has been outlined above, this court finds the defendant did not act in good faith with respect to the infringement here. The infringement was deliberate. Enough subsidiary facts appear in the master's report and are outlined in this opinion to support this ultimate finding. However, with respect to an increase in damages, I agree with Judge Brewster of this court in increasing damages where there was a deliberate infringement. That distinguished jurist, long the senior member of this court, stated in *Muther* v. *United Shoe Machinery Corp., supra,* [21 F. 2d 773,] 780: "While doubtless one of the purposes of the statute was to deter acts of infringement * * *, yet I do not conceive it to be the intent of the law to unjustly enrich the injured party at the expense of the wrongdoer." However, I believe full justice should be done to the plaintiff, the party wronged. The plaintiff has incurred considerable expense. There is little doubt that all the elements of damage done to the plaintiff are not included in the award made. On due reflection and

looking at the whole situation objectively, I believe if the award is increased fifty per cent, it will be adequate.

A judgment for the taxpayer was entered and United, taking no appeal, paid the judgment in full in April, 1944. The payment consisted of the following items (R. 108, 139):

(a) Damages for patent infringement	$63,355.00
(b) Interest on item (a)	28,020.54
(c) Increase in award	45,687.77
(d) Loss of profit on foreign sales	688.89
(e) Amount of judgment	137,752.20
(f) Interest on judgment to date of payment	609.72
(g) Total	$138,361.92

Taxpayer, in his 1944 income tax return, only included in gross income that part of the proceeds of the patent infringement, $688.89, which was awarded for loss of profit on foreign sales. The Commissioner, in determining the deficiency, allowed the taxpayer a deduction of $30,536.63 for litigation fees and expenses, and included the net amount of the recovery, $107,825.29, in taxpayer's gross income for 1944. In his explanation, the Commissioner rejected taxpayer's contention that since the award was for damages, it was not income, because it was the Commissioner's opinion that "the award appears to be entirely for profits,

royalties, and interest" and therefore constituted income for the year 1944. (R. 109.) The Tax Court approved the Commissioner's determination, holding that the entire award was for loss of income. It also held that the so-called tax benefit rule urged by the taxpayer to exclude a portion of the recovery from tax had no applicability. (R. 109-115.) The Court of Appeals affirmed. It agreed with the Tax Court that "the damages which the taxpayer sought and which the master awarded were not for loss or injury to capital but as compensation for profits or gains which the taxpayer would have enjoyed but for United's infringement." (R. 141.) It also rejected taxpayer's contention that even though the recovery was income, the "tax benefit rule" prevented imposition of the tax. (R. 141-142.)

ARGUMENT

1. The court below held, in complete harmony with the decided cases, that (R. 136) whether the net proceeds of litigation are taxable to the recipient as income or constitute a non-taxable return of capital "depends upon the object for which the suit was brought." If brought to recover "lost profits, the proceeds are taxable as income;" if brought "for loss or damage to capital, the proceeds are non-taxable." *Durkee* v. *Commissioner,* 162 F. 2d 184, 186 (C.A. 6th); *Raytheon Production Corp.* v. *Commissioner,* 144 F. 2d 110, 113 (C.A. 1st), certiorari denied, 323 U. S.

779; *Swastika Oil & Gas Co.* v. *Commissioner,* 123 F. 2d 382, 384 (C.A. 6th), certiorari denied, 317 U. S. 639; *Arcadia Refining Co.* v. *Commissioner,* 118 F. 2d 1010 (C.A. 5th); *H. Liebes & Co.* v. *Commissioner,* 90 F. 2d 932, 935 (C.A. 9th); *Farmers' & Merchants' Bank* v. *Commissioner,* 59 F. 2d 912, 913 (C.A. 6th). This principle has uniformly resulted in the holding that generally patent recoveries are ordinary income. *United States* v. *Safety Car Heating Co.,* 297 U. S. 88; *Martin Bros. Box Co.* v. *Commissioner,* 142 F. 2d 457 (C.A. 6th), affirming *per curiam* the memorandum decision of the Tax Court entered April 22, 1943 (1943 P-H T.C. Memorandum Decisions, par. 43,190); *Triplex Safety Glass Co.* v. *Latchum,* 44 F. Supp. 436 (D. Del.), affirmed *per curiam,* 131 F. 2d 1023 (C.A. 3d); *Commissioner* v. *S. A. Woods Mach. Co.,* 57 F. 2d 635 (C.A. 1st), certiorari denied, 287 U. S. 613; *First Bancredit Corp.* v. *Flexlume Corp.,* 10 F. Supp. 1015 (W.D. N.Y.); *Sly Mfg. Co.* v. *Commissioner,* 24 B.T.A. 65; *Christensen* v. *Commissioner,* 33 B.T.A. 79.

Taxpayer's objection to the decision (Pet. 5; Br. 9-12) is largely to the view of both courts below that the complaint in the patent litigation sought, and the award was made for, lost income and interest. This largely factual determination of the nature of the recovery is not only supported by the record, but a contrary view would have been erroneous as the two courts' analysis of the proceedings

in the patent litigation establishes. (R. 111-112; 140-141.) Taxpayer's assertions to the contrary (Pet. 5; Br. 11) are without support in the record and are, at best, in derogation of this Court's admonition in *Safety Car Heating Co., supra,* p. 98, that, "To determine what the respondent got we are to consider what it did, and not what it could have had if it had made another choice."

2. Taxpayer's contention (Br. 10-12) that the decision is inconsistent with *Helvering* v. *Taylor,* 293 U. S. 507, and *Durkee* v. *Commissioner,* 162 F. 2d 184 (C.A. 6th), is without merit. His belated effort to introduce evidence of the amount of damage to his capital caused by the infringement does not present the question decided by *Helvering* v. *Taylor, supra,* of the authority of a Court of Appeals to order a remand to the Tax Court where the taxpayer has established that the deficiency determined was too large, but has not, as is his burden, proved the correct amount. That question is not present here because the proffered proof pertaining to the basis of the capital allegedly destroyed by the infringement is irrelevant, as we have shown, *supra,* because the recovery sought and obtained was for lost income, not injury to capital.

3. The contention that in any event the recovery was a capital gain and not ordinary income (Pet. 5-6, 7; Br. 18-19) is also without merit. Gain from the sale or exchange of "capital assets" as defined in Section 117(a) (Appendix, *infra,* p. 13), is

treated as capital gain (Section 117(b), Appendix, *infra,* pp. 13-14), and the same treatment is accorded gain from the sale, exchange of conversion of a separately defined group of capital assets in Section 117(j) (Appendix, *infra,* p. 14). Taxpayer's contention on this point fails for the same reason as does his contention discussed, *supra.* The recovery was not obtained because of injury to capital assets. The contention is additionally deficient because there was no sale, exchange or conversion as required by the statute. Cf. *Helvering* v. *Flaccus Leather Co.,* 313 U. S. 247, 249; see also *Fairbanks* v. *United States,* 306 U. S. 436; *Burnet* v. *Harmel,* 287 U. S. 103; *Helvering* v. *Hammel,* 311 U. S. 504; *Dobson* v. *Commissioner,* 321 U. S. 231, denying rehearing of decision in 320 U. S. 489.

4. Taxpayer's contention that the decision is inconsistent with *Dobson* v. *Commissioner,* 320 U. S. 489 (Br. 13) in that the "tax benefit rule" was not held applicable (Pet. 5, 7) is both inaccurate and presents no occasion for the issuance of the writ. It was stated in *Dobson* that (p. 506), "We are not adopting any rule of tax benefits. * * *" Nor is there any occasion as taxpayer suggests (Br. 15-16) for this Court to now announce a "tax benefit rule." This has been done by Congress. Section 22(b)(12), Internal Revenue Code (Appendix, *infra,* pp. 12-13). This case does not come within that statute for various reasons, the most important of which is that the doctrine, originated by the Tax

Court, as noted by this Court in *Dobson* v. *Commissioner, supra,* and now codified, deals solely with recoveries that are income for tax purposes rather than a return of capital, only because of a previous tax deduction. That problem is not presented here because taxpayer's recovery, as we have shown, was not due to the recovery of a previous tax deduction but an award of damages for lost income.

CONCLUSION

The decision below is correct. There is no conflict of decisions or any other reason justifying the issuance of a writ of certiorari.

Respectfully submitted,

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APRIL, 1950

APPENDIX

Internal Revenue Code:

SEC. 22. GROSS INCOME.

(a) *General Definition.*—"Gross income" includes * * * gains or profits and income derived from any source whatever. * * *

(b) *Exclusions from Gross Income.*—The following items shall not be included in gross income and shall be exempt from taxation under this chapter:

* * * * *

(12) [as added by Section 116 of the Revenue Act of 1942, c. 619, 56 Stat. 798] *Recovery of bad debts, prior taxes, and delinquency amounts.*—Income attributable to the recovery during the taxable year of a bad debt, prior tax, or delinquency amount, to the extent of the amount of the recovery exclusion with respect to such debt, tax, or amount. For the purposes of this paragraph:

(A) Definition of Bad Debt.—The term "bad debt" means a debt on account of worthlessness or partial worthlessness of which a deduction was allowed for a prior taxable year.

(B) Definition of Prior Tax.—The term "prior tax" means a tax on account of which a deduction or credit was allowed for a prior taxable year.

* * * * *

(D) Definition of Recovery Exclusion. The term "recovery exclusion", with respect to a bad debt, prior tax, or delinquency amount, means the amount, determined in accordance with regulations prescribed by the Commissioner and with the approval of the Secretary, of the deductions or credits allowed, on account of such bad debt, prior tax, or delinquency amount, which did not result in a reduction of the taxpayer's tax under this chapter (not including the tax under section 102) or corresponding provisions of prior revenue laws, reduced by the amount excludible in previous taxable years with respect to such debt, tax, or amount under this paragraph.

* * * * *

(26 U.S.C. 1946 ed., Sec. 22.)

SEC. 117. CAPITAL GAINS AND LOSSES.

(a) *Definitions.*—As used in this chapter—

(1) *Capital Assets.*—The term "capital assets" means property held by the taxpayer (whether or not connected with his trade or business), but does not include * * *

* * * * *

(b) [amended by Section 150(c) of the Revenue Act of 1942, *supra*] *Percentage Taken Into Account.*—In the case of a taxpayer, other than a corporation, only the following percentages of the gain or loss recognized upon the

sale or exchange of a capital asset shall be taken into account in computing net capital gain, net capital loss, and net income:

100 per centum if the capital asset has been held for not more than 6 months;

50 per centum if the capital asset has been held for more than 6 months.

* * * * *

(j) [as added by Section 151 of the Revenue Act of 1942, *supra*] *Gains and Losses From Involuntary Conversion and From the Sale or Exchange of Certain Property Used in the Trade or Business.*—

* * * * *

(2) *General Rule.*—If, during the taxable year, the recognized gains upon sales or exchanges of property used in the trade or business, plus the recognized gains from the compulsory or involuntary conversion (as a result of destruction in whole or in part, theft or seizure, or an exercise of the power of requisition or condemnation or the threat or imminence thereof) of property used in the trade or business and capital assets held for more than 6 months into other property or money, exceed the recognized losses from such sales, exchanges, and conversions, such gains and losses shall be considered as gains and losses from sales or exchanges of capital assets held for more than 6 months. * * *

* * * * *

(26 U.S.C. 1946 ed., Sec. 117.)

Treasury Regulations 111, promulgated under the Internal Revenue Code:

> SEC. 29.22(b)(12)-1 [as amended by T.D. 5454, 1945 Cum. Bull. 68]. RECOVERY OF CERTAIN ITEMS PREVIOUSLY DEDUCTED.—(a) *In general.*—Section 22(b)(12) provides that income attributable to the recovery during any taxable year of bad debts, prior taxes, and delinquency amounts shall be excluded from gross income to the extent of the "recovery exclusion" with respect to such items. The rule of exclusion so prescribed by statute applies equally with respect to all other losses, expenditures, and accruals made the basis of deductions from gross income for prior taxable years, including war losses referred to in section 127, but not including deductions with respect to depreciation, depletion, amortization, or amortizable bond premiums. (See *Dobson* v. *Commissioner,* 64 S. Ct. 239.) The term "recovery exclusion" as used in these regulations means accordingly an amount equal to the portion of the bad debts, prior taxes and delinquency amounts (the items specifically referred to in section 22(b)(12), and of all other items subject to the rule of exclusion which, when deducted or credited for a prior taxable year, did not result in a reduction of any tax of the taxpayer under Chapter 1 of the Internal Revenue Code (other than a tax under section 102) or under corresponding provisions of prior revenue laws.

* * * * *

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